STICKY NOTES BY THE IIF

Welcome back to Sticky Notes, the IIF's review of events we're watching in international economics and politics.

We are planning an "all politics" edition of Sticky Notes ahead of the U.S. midterm elections on November 6th. If you have any topics you want us to address or questions to answer, please let us know by emailing us at stickynotes@iif.com.

This week:

- I look at the implications of U.S. Vice President Mike Pence's recent speech on China.
- Scott Farnham provides a rundown of U.S. trade issues.

Thanks for reading,

Kristen

Implications of VP Pence's Speech on China

While all of Washington was preoccupied with the Kavanaugh confirmation, Vice President Pence delivered a humdinger of a speech on October 4th at the Hudson Institute, where he denounced China's "whole of government" approach to "undermine support for the President, our agenda, and our nation's most cherished ideals." The speech outlined U.S. grievances around Chinese trade practices, Chinese investment and lending, military expansion, domestic surveillance, interference in U.S. elections, and Chinese human rights. The speech didn't pull any punches. China's Global Times dismissed the speech as a ploy to win over mid-term voters, and a Chinese Foreign Ministry spokesman voiced China's commitment to "joining hands with the U.S. to work for non-conflict, non-confrontation, mutual respect and win-win cooperation." In the U.S., though, most China experts thought the speech was consequential. As Walter Russell Mead asked in the Wall Street Journal, "Did Cold War II break out last week while no one was watching?"

On the one hand, there's a strong case that U.S. policy toward China has unalterably shifted. It's remarkable, particularly for alumnae of previous U.S. Administrations, how decisively a U.S. bipartisan consensus has developed around China policy, an area that has been plagued with equivocation since 1972. The Trump Administration has received bipartisan support for tariffs against Chinese products (see below), arms sales and other military cooperation with Taiwan, increased Freedom-of-Navigation exercises in the South China Sea, increased B-52 overflights of the East and South China seas, foreign investment reform, and so on. While most elements of Trump's foreign policy — North Korea, Iran, Syria, Russia — have engendered a constant drumbeat of skepticism, the President's actions against China continue to enjoy broad support in Washington, even where they have resulted in retaliatory tariffs against key Republican political constituencies. This has given the Administration a huge amount of running room to consider additional forms of pressure.

However, despite consensus on specific short-term actions, there is still a substantial question about where the U.S. is headed long-term in the dispute with China, a point we've discussed previously. Is the Trump Administration fundamentally concerned with the trade imbalance with China, which could be addressed with increased exports? Or will the U.S. insist on measures that stall China's progress as a competitor by deterring forced technology transfers? Or is the U.S. attempting something even more ambitious — to decouple its economy from China's, allowing the U.S. to challenge China even more directly?

Chinese officials believe that President Trump, personally, is concerned principally with trade imbalances and could be assuaged with measures to

support U.S. manufacturing jobs. That approach might find some support from market-focused advisors including Secretary Mnuchin and Larry Kudlow. However, his Administration is full of China hawks, including National Security Advisor Bolton and Secretary of State Pompeo, who are reportedly coordinated internally and with U.S. allies. The Pence speech was a clear win for the more hardline approach; it has significantly moved the bar on any possible negotiations with China. Now that the Vice President has committed the U.S. not to "relent until our relationship with China is grounded in fairness, reciprocity, and respect for sovereignty," it will be even more difficult for the Administration to cut a deal focused on modest trade concessions.

To answer Mead's question, we think — in Cold War terms — of 1946. The U.S. was coming to grips with the Soviet threat, but had not yet developed a clear consensus on either Soviet intentions or a strategy for confronting them. George Kennan, the Charge d'Affairs in Moscow, wrote the so-called Long Telegram, a version of which was published a year later anonymously in Foreign Affairs as the "X Article." Kennan's recommendation to apply "unalterable counterforce at every point where [the Soviets] show signs of encroaching upon the interest of a peaceful and stable world" formed the basis of U.S. containment policy until 1991.

Today, the U.S. approach to China is pre-Kennan — consensus on the grievances but no clear voice to outline U.S. priorities or a long-term strategy. In the meantime, the odds of a quick resolution or a return to the uneasy but accomodating U.S.-China relationship of the past decade remains quite low.

U.S. Trade Roundup

Trump turns up the heat on China. The U.S. and China both started imposing additional tariffs on September 24th, and we have seen a significant deterioration in U.S.-China relations since then. President Trump's speech in front of the UN General Assembly doubled down on his "America First" agenda, while his subsequent comments to the media suggested a waning in his affection for President Xi. As discussed above, Vice President Pence's speech pulled no punches. Next week's release of the Treasury's report on "Macroeconomic and Foreign Exchange Policies of Major Trading Partners" may also increase tension given the Administration's frequent comments on currency manipulation. As we wrote in July, we believe the chances of the U.S. officially naming China a currency manipulator are slim-to-none.

Regarding future tariffs on Chinese goods, USTR has not yet announced the official start of a new round of tariffs – potentially including the rest of the $267 billion worth of products imported from China not yet targeted by earlier tariff rounds. As mentioned in a prior Note, we expect an announcement soon, with implementation of tariffs on some grouping of products early next year. China is virtually out of U.S. products to retaliate against, with the notable exception of aircraft and aircraft parts, so any retaliation will likely be in the form of "soft sanctions" (discussed in prior Sticky Notes) or by letting their currency depreciate further. Our economists believe China's currency has already baked in the initial round of U.S. 25% tariffs on $50 billion worth of products and the 10% tariffs on $200 billion worth of products, but the planned rate increase to 25% in January and any additional tariffs will require more depreciation to offset the effects (see Weaponizing the RMB).

Skirting the tariffs? There has been anecdotal evidence of U.S. and Chinese companies trying to find ways to avoid paying tariffs. One less controversial route involves moving manufacturing (or finding a new supplier) from China to another low-cost producer such as Vietnam, Malaysia, etc. There are also reports of efforts to change the destination of origin of products by replacing "Made in China" labels with "Made in Country X" labels. Some observers argue that shifting production to other southeast Asian countries - via overt or covert efforts - could place a target on these countries for future Trump tariffs. If Trump is truly concerned with the overall trade deficit, which would not be narrowed in the case of moving manufacturing from one foreign country to another, then he could look to place tariffs on other countries. However, with such time and effort spent going after China, he may be satisfied with the optics of a decline in the deficit with China.

"New" NAFTA Moves Forward. It's been nearly two weeks since the U.S., Mexico, and Canada published the text of the revised NAFTA – the U.S.-Mexico-Canada agreement (USMCA) – with hours to spare before their self-

imposed September 30th deadline. Since then, officials from all three sides have claimed victory, both for their national interests and for the North American region as a whole. Major U.S. business and labor groups have been, on balance, positive, though many groups are still reviewing the fine details before they agree to throw full support behind the deal. Reaction in Canada and Mexico has been mixed; industry groups cite shortcomings to the deal but are generally relieved that an agreement was reached. The agreement is on pace for signing prior to December 1st when the new Mexican Administration takes office – all three leaders will be in Buenos Aires at the end of November for the G-20 meeting, so that's a possibility. Keeping with the Trade Promotion Authority (TPA) timeline, we could see a vote on the agreement in the U.S. Congress around Q2 2019.

As President Trump transitions from negotiating to selling the deal domestically, one of the main challenges is the deal's similarity to the original NAFTA and CPTPP agreement – both huge targets of criticism in Trump's trade talking points. He will be asking members to vote to approve a deal that is very similar to deals he has derided as "the worst trade deal ever" (NAFTA) and a "potential disaster for our country" (TPP). He will likely point to some of the key differences including: 1. Changes to auto sector rules of origin and labor content rules; 2. changes to investor-state dispute settlement and De Minimis thresholds; 3. inclusion of digital trade and increased IP protections; 4. inclusion of a sunset review mechanism; 5. increased agriculture/dairy sector access to Canada; 6. and addition of a currency section and an anti-non-market economy FTA provision.

The currency section – which seeks to avoid currency manipulation/ competitive devaluation – is mainly a formality, as neither Mexico or Canada are accused of that behavior. Instead, the section was included as a template for deals going forward, and to formalize the U.S. position on currency manipulation with regard to trade. In fact, addressing currency issues has been a key U.S. trade negotiating objective since the latest version of Trade Promotion Authority was passed in 2015.

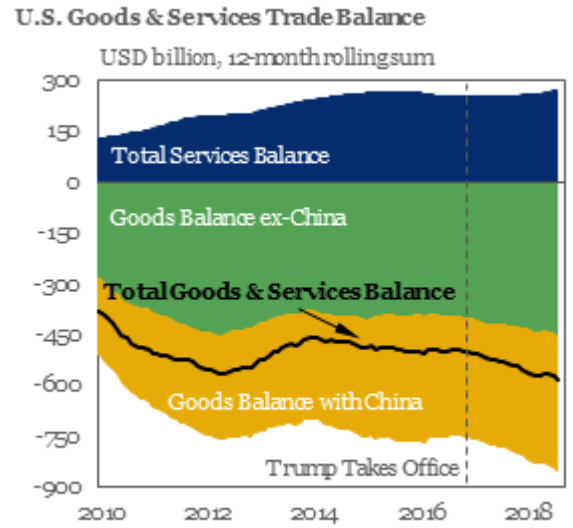
One provision in the deal makes a trade or investment deal with a non-market economy a "poison pill" for the USMCA – essentially granting the U.S. the right to withdraw from the USMCA if Canada or Mexico reach an agreement in China (or other non-market economies). This will also serve as a selling point to Congress.

Abe reels in Trump. Following discussions at the UN in New York, President Trump and Japan PM Shinzo Abe agreed to begin bilateral trade talks with the hope of working out something on auto trade, in particular. Importantly, Japan will be protected from potential U.S. tariffs on auto imports during negotiations – a similar agreement Trump made with the EU.

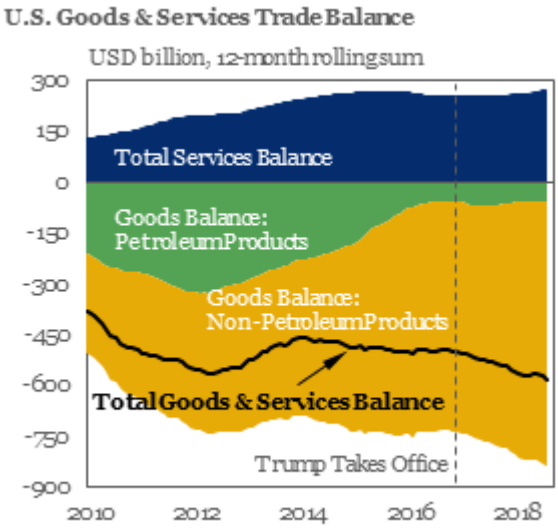
As for the prospect of auto tariffs, the Department of Commerce delayed the release of the Section 232 report – in part due to complex analysis involved and the ongoing negotiations with key countries in auto trade. Commerce has until mid-February to release its findings to the President for approval or denial. However, ongoing discussions with the EU and Japan, plus the important USMCA side-agreement shielding Mexico and Canada from auto tariffs in exchange for quotas, limit the initial bite auto tariffs would have.

U.S. Trade Deficit Widens. U.S. trade data for August showed a widening of the total goods and services balance to $53 billion from $50 billion in July, as exports decreased and imports increased – a signal of underlying strength in domestic consumption. Keeping with the post-U.S. oil boom trend, the widening goods deficit is primarily in non-petroleum products, as U.S. domestic oil production has cut the petroleum product goods deficit by over $250 billion since 2012.

Against President Trump's wishes, the trade-in-goods deficit with China also widened to nearly $400 billion over the past 12 months. This compares to a deficit of $350 billion when he took office. What's more, September trade data released Thursday night by China showed a record trade surplus with the U.S. – perhaps reflecting U.S. companies front-loading orders ahead of the late-month implementation of more tariffs.



Source: Census Bureau, IIF



Source: Census Bureau, IIF

Tweet of the Week

In lieu of a single tweet of the week, we suggest everyone keep up with the discussion at our ongoing Annual Membership Meeting in Bali by following our Twitter account @IIF and the hashtag #IIFbali.

1333 H Street NW, Suite 800 E, Washington, DC 20005-4770